

# Hastings International and Comparative Law Review

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Volume 5  
Number 3 *Spring 1982*

Article 9

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1-1-1982

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### Recommended Citation

John P. McDonnell, *An Overview of Outbound Foreign Investment*, 5 HASTINGS INT'L & COMP.L. Rev. 595 (1982).  
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# An Overview of Outbound Foreign Investment

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## I. INTRODUCTION: JURISDICTION

The United States taxes its citizens and residents on their worldwide income. Thus, as a general matter, United States citizens and residents with foreign investments or business operations will pay U.S. tax on their profits from these activities. In addition, the United States taxes foreign taxpayers on their income derived from U.S. sources, and in certain limited instances, taxes foreign income of foreign taxpayers also. *See Internal Revenue Code (I.R.C.) § 864(c)(4) (1967 & Supp. 1982).* This leaves a substantial amount of the world's income free from U.S. tax. Generally, the foreign source income of a foreign taxpayer is not subject to U.S. tax. Significantly, a foreign corporation that is owned by U.S. taxpayers qualifies as a foreign taxpayer. Thus, "outbound foreign investments" include foreign activities by U.S. taxpayers and foreign activities by corporations owned by U.S. taxpayers.

## II. THE LINCHPIN: THE FOREIGN TAX CREDIT

- A. The foreign tax credit is the linchpin that makes the United States system of worldwide taxation possible. The United States is certainly not interested in using its tax system to discourage foreign investment or foreign business operations. However, if we assume, for example, that the United Kingdom imposed a 60% tax on the profit earned by a U.S. taxpayer in the United Kingdom and the United States imposed a 50% tax on the same profits, then it is

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\* This outline was prepared for Mr. McDonnell's presentation and was provided to all attendees.

clear that the U.S. taxpayer is not going to enter the investment that yields a loss of 10%. In the past, most countries eliminated this problem of double taxation by exempting foreign income from taxation. The United States did not wish to grant such an exemption nor did it wish to cause double taxation. The foreign tax credit was the United States' solution to this problem. For a discussion of the history of the foreign tax credit (as well as a discussion of all other aspects of the foreign tax credit), see E. Owens, *The Foreign Tax Credit* (1961).

- B. Generally, foreign income taxes are allowed as a direct credit against the amount of U.S. tax liability, thereby eliminating for practical purposes the effect of the foreign tax. The elimination of double taxation is shown in the following example:

Example 1

	<u>United States</u>		<u>Mexico</u>
\$ 100	U.S. source income	\$ 100	Mexico source income
100	Mexico source income		
\$ 200	total taxable income		
\$(100)	U.S. tax @ 50%	\$( 40)	Mexican tax @ 40%
40	credit for Mexican taxes		
\$( 60)	net U.S. taxes		

total taxes = \$100 (\$60 U.S. and \$40 Mexico)

If the United States merely allowed a deduction for the Mexican tax, however, double taxation would not be eliminated:

Example 2

	<u>United States</u>		<u>Mexico</u>
\$ 100	U.S. source income	\$ 100	Mexico source income
100	Mexico source income		
( 40)	deduction		
\$ 160	net taxable income		
\$( 80)	U.S. @ 50%	\$( 40)	Mexican tax @ 40%

total taxes = \$120 (\$80 U.S. and \$40 Mexican)

In effect, the U.S. would be taxing both the U.S. source income (\$100) at 50% for a \$50 tax and the *net* foreign source income (\$60 after foreign tax) at 50% for a tax of \$30. (Note that under I.R.C. § 275(1)(4) a taxpayer that

elects the foreign tax credit cannot claim a deduction for foreign income taxes.)

- C. As can be seen in Example 1 above, when a foreign tax credit is granted, the total tax paid is equal to the U.S. tax rate on the total income (\$100 tax on \$200 total worldwide income). Thus, the use of the foreign tax credit allows the United States to collect a tax on foreign source income whenever the foreign tax rate is lower than the U.S. tax rate. Example 1 demonstrates that the United States has effectively imposed a \$10 tax on the foreign source income. If the United States granted an exemption for foreign source income, however, there would be no U.S. tax on the foreign source income. Thus, a credit mechanism is generally more beneficial to the taxing authorities than an exemption mechanism.
1. On the other hand, if the foreign tax rate is greater than the U.S. tax rate, the credit mechanism may reduce the U.S. tax on U.S. source income. If the Mexican tax in Example 1 had been a \$55 tax, then the credit would have been \$55 and the net U.S. taxes only \$45. Thus, the taxpayer would not have paid the full 50% U.S. tax on the U.S. source income. Therefore, U.S. law is designed to limit the amount of the foreign tax credit so that the credit does not exceed the U.S. tax that would have been imposed on the foreign source taxable income.
  2. The limitation is provided in I.R.C. § 904. The foreign tax credit limit can be expressed as the following formula:
$$\text{foreign tax credit} = \text{U.S. tax} \times \frac{\text{foreign source taxable income}}{\text{worldwide taxable income}}$$
    - a. In order to assure that the ratio of taxable foreign income to taxable worldwide income remains proper, the foreign tax credit limit incorporates complex rules for determining the deductions that will be used to offset foreign source gross income. These rules are set forth in Treas. Reg. § 1.861-8 (1954).
    - b. The calculation of the foreign tax credit limit is of vital importance to all U.S. taxpayers paying for-

eign taxes. The intricacies of calculating the credit limit under section 904 and Treas. Reg. § 1.861-8 are covered at length in the presentation of Mr. Chilton.

- D. The credit is allowed only for foreign "[i]ncome, war profits and excess profits taxes." I.R.C. § 275(a)(4) (1978). By far the most important category is foreign income taxes.
1. What constitutes an "income tax" has long been a source of dispute. In making the determination of whether a tax is an income tax, U.S. principles, rather than foreign principles, apply. *Biddle v. Commissioner*, 302 U.S. 573 (1938).
  2. The argument over the definition of a "foreign income tax" has become much more heated in recent years. *See Bank of America National Trust & Savings Association v. United States*, 459 F.2d 513 (Ct. Cl. 1972), *cert. denied*, 409 U.S. 949 (1972); Rev. Rul. 78-61, 1978-1 C.B. 221; *Inland Steel Co. v. United States*, 677 F.2d 74 (Ct. Cl. 1980); Temp. Treas. Reg. § 4.901-2 (1980).
  3. In order to qualify as a creditable foreign income tax a foreign charge must:
    - a. be imposed upon realized net income;
    - b. follow reasonable rules regarding source of income, residence, or other bases for tax jurisdiction; and
    - c. not be payment for a specific benefit from the foreign government.
  4. The complexities of the creditability issue are virtually endless. For example, requirement *a.*, above, is actually three requirements. First, the tax base must be income rather than non-income (such as gross receipts or rental value of property). Second, the income must be realized. Finally, the tax must generally allow for significant deductions so that it reaches net income. (*But see* Temp. Treas. Reg. § 4.901-2(c)(4)(iii) (1980) which provides an exception for foreign withholding taxes imposed on gross income.) For further analysis of this critical issue, see Chilton and Schaberg, *Creditability of Foreign Taxes*, 415 Tax Mgmt. Portfolio; American Bar Association, *The Creditability of Foreign Income*

*Taxes; A Critical Look at Revenue Rulings 78-61, 78-62 and 78-63, 32 Tax Law. 33 (1978).*

- E. The indirect or "deemed paid" credit. Recognizing that U.S. businesses often desire or are required to conduct their overseas operations through subsidiaries rather than branches, Congress extended the foreign tax credit to allow a credit for foreign income taxes paid by such subsidiaries. Thus, the indirect credit has the same purpose as the direct credit: the elimination of double taxation. However, the provisions of the indirect credit are much more complicated than the direct foreign tax credit.

1. Under I.R.C. § 902, a domestic corporation which owns 10% or more of the stock of a foreign corporation and which receives dividends from the foreign corporation is entitled to a credit under the following formula:

$$\text{credit} = \text{foreign taxes paid} \times \frac{\text{dividend}}{\text{accumulated profits}}$$

The above formula is merely a shorthand expression of a much more convoluted formula which has in turn been developed in the case law and amended several times. See 1 E. Owens & G. Ball, *The Indirect Credit*, 40-94 (1975-1979).

2. A taxpayer electing the benefits of a credit under section 902 must also include the amount of the credit as dividend income under section 78. In the absence of this "gross-up" provision, there could be a deduction and a credit for the same tax. The double benefit of a deduction and credit was effectively eliminated by *American Chicle Co. v. United States*, 316 U.S. 450 (1942), but the addition of section 78 and further amendments to section 902 were necessary to make the election function properly.
3. The potential complexities in section 902 are legion. For example, the ratio of dividends to accumulated profits can be distorted if different rules are used for calculating the earnings and profits for purposes of the dividend and the earnings and profits for purposes of the accumulated profits. See *H.H. Robertson Co. v. Commissioner*, 59 T.C. 53 (1972). Also, if a foreign subsidiary has an operating loss, the credit for taxes

paid in prior years may be partially lost. *See* Rev. Rul. 74-550, 1974-2 C.B. 209.

- F. The indirect credit has also been extended to allow a credit for foreign income taxes paid by second tier and third tier foreign subsidiaries. *See* I.R.C. § 902(b) (Supp. 1982). No credit is allowed for taxes paid by lower tier subsidiaries.

### III. U.S. TAXPAYERS INVESTING AND DOING BUSINESS OVERSEAS—GENERALLY

- A. A U.S. individual or corporation that directly owns investments overseas and receives income from them is taxed in a direct fashion. The foreign investment income is subject to U.S. tax, and the deductions, if any, attributable to the income are determined under Treas. Reg. § 1.861-8 (1954). The taxpayer is entitled to a foreign tax credit as discussed above.

In order to defer, or possibly eliminate, the U.S. taxation of foreign investments, U.S. taxpayers have attempted to shift such foreign investments to foreign corporations which are not subject to U.S. tax. The use of such foreign corporations is discussed in section IV, *infra*.

- B. U.S. taxpayers conducting direct business operations overseas normally do so through a foreign branch or foreign partnership.
1. Generally, the income and deductions of a foreign branch operation are included in calculating the liability of the U.S. taxpayer.
    - a. On the income side, the source of the income is determined under I.R.C. § 861. If a foreign branch operation generates U.S. source income (for example, by collecting interest on a sale to a U.S. resident), the fact that the income was earned by a foreign branch does not change the source of the income. *See, e.g., Sumitomo Bank, Ltd. v. Commissioner*, 19 B.T.A. 480 (1930).
    - b. The deductions of a foreign branch operation are determined pursuant to Treas. Reg. § 1.861-8. Under this regulation, some of the deductions actually paid by the foreign branch (and considered part of the branch operations for accounting pur-

poses) might not be deductible against the income of the branch. For example, interest and research expenses may be apportioned on the basis of the U.S. taxpayer's total assets and total sales. Conversely, a portion of the expenses that are not incurred or paid by the branch might be used to reduce the branch income. For example, certain general administrative expenses might be properly apportioned on the basis of foreign and domestic gross income, and thus a portion of these U.S. expenses might offset the income of the foreign branch operation.

- c. Generally, life is less complicated if the foreign branch operations produce net taxable profit. If the foreign source deductions exceed the foreign source income, there will be an overall foreign loss, which must be recaptured by reducing future foreign source income. I.R.C. § 904(f) (Supp. 1982). The recapture of foreign losses can be quite complex, and possibly unfathomable. *See Dale, The Reformed Foreign Tax Credit: A Path Through the Maze*, 33 Tax L. Rev. 175, 209-222 (1978).
  - d. A foreign branch generating losses in the early years of its operations might be incorporated when it begins to produce profits. Naturally, the Internal Revenue Service frowns upon such an action and has stated that it will refuse to issue a favorable outbound ruling under I.R.C. § 367. Rev. Rul. 78-201, 1978-1 C.B. 91. The Tax Court has refused to support the Service on this issue. *See Hershey Foods Corp. v. Commissioner*, 76 T.C. 312 (1981). Outbound rulings are discussed in section VI, *infra*.
2. As an exception to the general rule, the income and deductions of a foreign branch operation are not included in calculating the U.S. taxpayer's income if the income of the foreign branch cannot be remitted to the United States due to currency restrictions in the foreign country. Thus, the tax effects of blocked foreign income are deferred until the income is remittable to the U.S. *See* Rev. Rul. 74-351, 1974-2 C.B. 144. *See also*



Ravenscroft, *Taxation and Foreign Currency*, ch. 5 (1973).

C. Entity characterization.

1. When a U.S. taxpayer chooses to conduct its foreign business operations through a partnership or joint venture, it is normally expecting to generate substantial front-end losses and is also expecting tax deductions for such losses.
2. Conversely, a U.S. taxpayer choosing to conduct its foreign business operations through a foreign corporation may be anticipating that the profits of the corporation will not be subject to U.S. tax.
3. Both of the above expectations can be frustrated if a foreign partnership is classified as a corporation for tax purposes or a foreign corporation is classified as a partnership for tax purposes. Foreign laws create numerous types of entities that can engage in business operations, and these operations may not be easily classified for U.S. tax purposes. For example, depending on the facts involved, the German *Gesellschaft mit beschränkter Haftung* (GmbH) and the Brazilian *limitada* have been classified as both a corporation and a partnership. See Rev. Rul. 77-214, 1977-1 C.B. 408; *Report on Foreign Entity Characterization for Federal Income Tax Purposes*, 35 Tax L. Rev. 167 (1980).

#### IV. INVESTING AND DOING BUSINESS THROUGH FOREIGN CORPORATIONS

The immediate lure for using a foreign corporation is the generation of income without U.S. tax. For example, it would be quite advantageous if the U.S. individual could place his General Motors stock in a Netherlands Antilles corporation and collect dividends without paying U.S. or Netherlands Antilles tax. See Lowe, *Curacao Investment Companies: Some Shoals in a Tax Haven*, 16 Tax L. Rev. 177 (1961). However, the use of foreign tax havens as a repository for a portfolio of passive investments has been substantially curtailed by the enactment of (1) the foreign personal holding company provisions, (2) the foreign investment company provisions, and (3) the controlled foreign corporation provisions.

- A. The foreign personal holding company (FPHC) provisions were enacted in 1937 to do away with the so-called “incorporated pocketbooks” that wealthy individuals maintained in such offshore tax havens as the Bahamas. Under I.R.C. § 551, the undistributed foreign personal holding company income (defined below) is taxed to the shareholders as if the foreign corporation had distributed this income on the last day of the year. However, this “deemed dividend” treatment occurs only if the foreign corporation meets the definition of a foreign personal holding company.

Under section 552, a company is considered a foreign personal holding company if it meets the (a) gross income requirement and (b) stockownership requirement.

1. The gross income requirement is met if at least 60% of the company’s gross income is “foreign personal holding income.” Foreign personal holding company income is defined in section 553 and includes primarily passive income, such as dividends, interest, royalties, gains from the sale of stocks and securities, and rents. (However, rental income is not included if it comprises more than 50% of the income of the company.)
  2. The stock ownership requirement is met if at any time during the taxable year more than 50% of the stock of the company is owned by not more than five United States citizens or residents. Thus, to avoid the stock ownership requirement there must be at least ten shareholders. However, section 554 contains broad constructive ownership rules that require the ten shareholders to be totally unrelated.
- B. One solution to the foreign personal holding company provisions was to depersonalize the company by having hundreds or thousands of shareholders. The “foreign investment company” presented an opportunity for the U.S. taxpayer to allow his investments to grow offshore, and then sell his stock at a later date and generate capital gain. The desirability of a foreign investment company was substantially eliminated by the enactment of sections 1246 and 1247.
1. Section 1246 provides that, unless a company elects to be taxed under section 1247, the gain from the sale of

the stock of the foreign investment company is converted to ordinary income to the extent of the earnings and profits of the company.

2. Under the section 1247 election, the foreign investment company could elect to be taxed substantially similar to a domestic investment company. *See* I.R.C. §§ 851-855 (1967 & Supp. 1982). Generally, those investment companies are required to distribute 90% of their income annually.
- C. A controlled foreign corporation can be used in the same fashion as a foreign personal holding company. Therefore, it is not surprising that the investment income of a controlled foreign corporation is taxed to its shareholders in the same manner that the foreign personal holding company income is taxed to the shareholders of a foreign personal holding company. *See* section V, *infra*. In the case of a foreign corporation subject to both the foreign personal holding company provisions as well as the controlled corporations provisions, section 951(d) provides that the FPHC provisions control. However, the overlap situation causes a considerable degree of confusion. *Compare Estate of Whitlock v. Commissioner*, 494 F.2d 1297 (10th Cir. 1974), *cert. denied*, 419 U.S. 839 (1974), with *Estate of W.R. Lovett v. United States*, 621 F.2d 1130 (Ct. Cl. 1980).

## V. CONTROLLED FOREIGN CORPORATIONS: SUBPART F

- A. This is the area of law that will have the most impact on major multinational companies doing business overseas. Even if a foreign corporation is *wholly* owned by a widely held domestic corporation, the foreign subsidiary will not be a foreign personal holding company. In determining the number of shareholders of the foreign corporation, stock owned by any corporation is considered to be owned by its shareholders. Thus, it is the ultimate ownership by individuals that determines whether a foreign corporation is a foreign personal holding company. On the other hand, the controlled foreign corporation provisions look to the direct ownership of the foreign corporation. Therefore, a foreign corporation owned entirely by a domestic corporation will be a controlled foreign corporation.

As discussed above, a foreign corporation is a potential vehicle for generating income free from U.S. tax.

1. Just as an individual should not be allowed to shift his investment income to a tax haven, there is no reason that a major multinational corporation should be allowed to create investment holding companies in off-shore tax havens. Therefore, when a controlled foreign corporation serves the same function as a personal holding company, the investment income is drawn into the net of U.S. taxation.

2. Furthermore, there are substantial tax advantages to conducting international business operations through a foreign base company located in a tax haven. *See Gibbons, Tax Effects of Basing International Business Abroad*, 69 Harv. L. Rev. 1206 (1956).

The use of a foreign base company has several advantages. One of the principal uses of the base company is as an intermediary in the business operations of the multinational corporation. Thus, a U.S. corporation could establish a base company and grant to it the worldwide distribution rights for the export of the U.S. company's products. The base company might work with related companies in foreign countries or unrelated parties in those countries. In any event, a portion of the profits on the export operations would be earned tax-free by the base company rather than in the U.S. or the foreign country where the property was ultimately sold or used. (Note that section 482, discussed in section VII, *infra*, would be applicable here.)

- B. In response to the abuses of tax haven investments and operations, in 1962 Congress enacted Subpart F of the Internal Revenue Code (sections 951 through 964) as a large-scale exception to the rule that the income from business operations of a foreign corporation is not subject to U.S. tax. Under Subpart F, the "Subpart F income" of a controlled foreign corporation is included in the current income of the U.S. shareholders of the controlled foreign corporation. (Note that since the included income is considered a dividend, the U.S. shareholder is entitled to a "deemed paid" credit under section 902.)

1. A controlled foreign corporation is defined in section

957 as a foreign corporation of which more than 50% of the total combined voting power of all voting stock is owned (directly or indirectly) by United States shareholders.

- a. A United States shareholder for this purpose includes only a U.S. person that owns 10% or more of the voting stock of the corporation. I.R.C. § 951(b) (1967). A U.S. "person" is defined in section 7701(a)(1) to include all U.S. taxpayers whether individuals, corporations, estates or trusts.
  - b. Therefore, a foreign corporation owned in equal parts by eleven unrelated shareholders would not be a controlled foreign corporation, because there would be no shareholder that owned 10% or more of the stock. (Again, broad constructive ownership rules apply to treat family members and controlled entities as related shareholders. *See* I.R.C. § 958 (1967 & Supp. 1982).)
  - c. Other efforts to decontrol a foreign corporation by granting formal voting control to a foreign shareholder have not been as successful. Despite the clear language of the statute requiring more than 50% voting control, courts have found corporations to be controlled in situations where the U.S. shareholders owned 50% or less of the voting stock. *See Garlock, Inc. v. Commissioner*, 49 F.2d 197 (2d Cir. 1973), *cert. denied*, 417 U.S. 911 (1974); *Koehring Co. v. United States*, 583 F.2d 313 (7th Cir. 1978).
2. Under section 951, there are three types of items which may be currently includable in the income of a United States shareholder of a controlled foreign corporation.
- a. The first, and by far the most important and expansive item, is the Subpart F income of the controlled foreign corporation. There are in turn several categories of Subpart F income.
    - 1) The first major component of Subpart F income is foreign personal holding company income. Under section 954(c), the foreign personal holding company income of a controlled foreign corporation is similar to the investment and other passive income discussed above under the

foreign personal holding company provisions. However, there are some modifications. For example, certain passive income, such as dividends, interest, and gains on sales of stock, are allowed to be received by banks and insurance companies provided they are received in the active conduct of a trade or business. As another example, certain passive income such as rents and royalties, can be received from a related person for the right to use property in the country where the controlled foreign corporation is organized. The exceptions and modifications to foreign personal holding company income are designed to facilitate legitimate international business operations conducted through controlled subsidiaries of U.S. corporations.

- 2) The second major component of Subpart F income is foreign base company income. This provision is designed to limit the siphoning of business profits into a tax haven, discussed above. There are three types of foreign base company income.
  - i) Foreign base company *sales* income can arise whenever a foreign base company purchases property from or sells property to a related party, unless the property is manufactured, produced, or sold for use in the base country. *See* I.R.C. § 954(d) (1967 & Supp. 1982).
  - ii) Foreign base company *services* income arises whenever services are performed for or on behalf of a related person, and the services are performed outside of the base country.
  - iii) In 1975, Congress added the third type of foreign base company income: foreign base company *shipping* income. Basically, this is income derived from the use or operation of ships or aircraft in international commerce.
  - iv) It should be noted that for purposes of clar-

ity, foreign personal holding company income has been distinguished from foreign base company income. Technically under section 954, foreign personal holding company income is merely one category of foreign base company income.

- 3) There are several other components of Subpart F income. These include income derived from the insurance of United States risks; any illegal bribes, kickbacks, or other payments made by the controlled foreign corporation to officials of foreign governments; and "boycott" income.

The "boycott" income is essentially a penalty provision enacted to discourage United States firms from cooperating with the Arab boycott of Israel. It is a complicated provision that has extensive reporting requirements. *See* I.R.C. § 999 (Supp. 1982). It has been pointed out on several occasions that there is no reason for the boycott provisions to be in the Internal Revenue Code because they are not motivated by any tax considerations. *See* Flynn and McKenzie, *International Boycotts*, 29 So. Cal. Tax. Inst. 139 (1977).

- 4) There are two escape valves that will cause income that is otherwise considered foreign base company income or foreign personal holding company income to become "untainted."

- i) First, if the foreign base company income, which includes foreign personal holding company income, is less than 10% of the gross income of the controlled foreign corporation, then none of the income of the foreign corporation is considered to be foreign base company income. I.R.C. § 954(b)(3) (Supp. 1982). (Note also that if more than 70% of the income of the corporation is foreign base company income, then *all* of the income is so treated.) Basically, the 10% exclusion allows any controlled foreign corporation to earn up to

that amount of its income from passive investments or from tainted dealings with related parties.

- ii) Also, under a very vague exclusion, the income will be excluded from foreign base company income if the corporation can convince the Secretary of the Treasury that it was neither formed nor used to reduce foreign taxes *and* that the transaction it entered into did not have tax reduction as a motive. I.R.C. § 954(b)(4) (Supp. 1982).
- 5) It is also important to note that under section 952(c) the Subpart F income of a controlled foreign corporation cannot exceed its earnings and profits. Thus, if a corporation generates a substantial deficit in earnings and profits, the corporation can earn Subpart F income (until the deficit is eliminated) without adverse tax consequences to the U.S. shareholders. The rules for computing the earnings and profits under Subpart F are critically important and are set forth in the regulations under I.R.C. § 964.
- 6) Finally, in computing the tainted foreign base company income and foreign personal holding company income, the gross income is reduced by the expenses properly allocable to such income. I.R.C. § 954(b)(5) (Supp. 1982). Therefore, only the net amount of the income is Subpart F income.
- b. The second type of income that may be included in the income of a U.S. shareholder is any amount of previously excluded income that is withdrawn from qualified investments in less developed countries (LDCs). Formerly, certain dividends and interest received from investment in less developed countries were not included as foreign personal holding company income. When the investment in the LDC was withdrawn, the amounts were required to be included in income. Also, previously excluded Subpart F income that is withdrawn from foreign base company shipping operations is included.



- c. The third amount that may be includable in the income of the United States shareholder is the controlled foreign corporation's increase in earnings invested in United States property under section 956.

- 1) This provision is completely different from the general Subpart F income provision, which seeks to include only tainted income. Basically, section 956 is a constructive dividend notion. If the controlled foreign corporation declared a dividend of its previously untaxed earnings, this amount would be taxable in the United States.

However, if the controlled foreign corporation makes its earnings economically available to its parent without the declaration of a dividend, the value of the earnings would not be taxed. The principal example is a long-term loan from the subsidiary to the parent.

Note also, that this provision is not restricted to controlled foreign corporations *directly* owned by U.S. shareholders. If a third-tier subsidiary has an increase in earnings invested in U.S. property, then there is a constructive dividend directly to the U.S. shareholder.

- 2) As originally enacted, section 956 prohibited an extremely broad range of investments in United States property. Tangible property located in the United States and stock of a domestic corporation could not be acquired by the controlled foreign corporation. In 1976, however, the categories of restricted investments were reduced. Now, provided the domestic corporation is not related to the controlled foreign corporation, the controlled foreign corporation can acquire stock or debt obligations of a domestic corporation. I.R.C. § 956(b)(2)(F) (Supp. 1982).
3. Since Subpart F requires some of the undistributed earnings of a foreign corporation to be taxed to the shareholders, section 959 provides that this previously taxed income is not again included in the income of the

U.S. shareholder when it is actually distributed. This rule becomes quite complex when the previously taxed income is distributed upward through a chain of corporations.

## **VI. I.R.C. SECTION 367: ORGANIZATION AND REORGANIZATION OF FOREIGN CORPORATIONS**

Despite Subpart F, there remain considerable tax and business advantages to operating a foreign subsidiary. However, Congress has long been concerned that a United States person may transfer assets to a foreign corporation that will sell the assets outside the net of United States tax. If the outbound transfer took the form of a sale, then it would be taxed in the U.S. However, if the outbound transfer is made as part of a tax-free incorporation under section 351, or a tax-free reorganization under section 368, then the assets may slip offshore without U.S. tax being imposed.

There is another major tax saving device that could be implemented offshore. Generally, a foreign corporation conducting a foreign business operation can accumulate a substantial amount of earnings offshore. The U.S. shareholder of the controlled corporation might seek to sell or liquidate the foreign corporation in order to convert the accumulated earnings into capital gains. (In the case of domestic corporations, this conversion is permitted under section 1001 or section 331. However, the earnings of a domestic corporation are subject to tax at the corporate level, whereas the earnings of a foreign corporation are normally not subject to such tax.) In order to more appropriately tax the income earned from foreign business operations, Congress enacted section 1248. Under section 1248, the capital gain realized by a U.S. shareholder upon the sale or liquidation of shares of a controlled foreign corporation is converted to ordinary income to the extent that the controlled foreign corporation has post-1962 earnings and profits.

Therefore, a U.S. shareholder wishing to avoid section 1248 might engage in a tax-free organization or reorganization of a foreign corporation so that the shares to be sold are owned by a foreign corporation. (Note that this device would require considerable planning efforts because the gain on the sale of the shares could be Subpart F income under section 954.) In order

to eliminate the abuses possible in a tax-free transfer of property outside the United States, Congress enacted section 367.

- A. Outbound transfers: I.R.C. section 367(a). As noted above, section 367 was enacted to prevent the tax-free transfer of assets offshore. The section provides that in the case of nonrecognition transfers, a foreign corporation would "not be considered to be a corporation." Since corporate status is a pre-requisite for nonrecognition under the applicable provisions, all of the transactions would be treated as sales (subject to current tax) rather than as tax-free transfers. However, a corporation would be regarded as a corporation (thereby allowing tax-free transfer) if the taxpayer obtained a ruling from the Secretary of the Treasury that the transfer was not in pursuance of a plan having tax avoidance as its principal purpose.
- B. In order to avoid issuing these rulings on an ad hoc basis, the Internal Revenue Service (IRS) issued ruling "guidelines" in Rev. Proc. 68-23, 1968-1 C.B. 821. This document notes that whether a particular transfer has tax avoidance as a purpose depends on "all the facts and circumstances" but also sets forth certain transactions that normally will (or will not) receive a favorable ruling.
  - 1. As a general rule, a favorable ruling will be granted for an outbound transfer only if the transferred property is to be devoted by the foreign corporation to the active conduct of a trade or business in a foreign country.
  - 2. It was further specifically indicated that a favorable ruling would normally not be issued for certain types of property. This includes inventory, accounts receivable, other installment obligations, and stock or securities.
  - 3. In certain instances, the IRS would grant a favorable ruling with respect to certain tainted assets, only if the taxpayer agreed to include an "appropriate amount" of income. Requiring an inclusion of income in order to obtain a tax-free 351 transfer or reorganization became known as the "toll charge" for outbound transfers.
- C. In 1976, section 367(a) was amended to eliminate the requirement that a ruling be secured *prior* to a transfer. Now, the ruling need only be submitted to the Treasury

within 183 days of the transfer. Furthermore, section 7477 has been inserted into the Code to allow the Tax Court to review the propriety of an unfavorable ruling issued by the IRS.

1. This is important because the Tax Court has overturned the IRS on several occasions. The Tax Court has ruled the facts involved in a case established that the transfer did not have tax avoidance as a principal purpose, and therefore the IRS could not deny a favorable ruling. *Dittler Bros. Inc. v. Commissioner*, 72 T.C. 896 (1979). The Tax Court has also ruled that the legal position taken by the IRS in denying certain rulings is without foundation. *See Hershey Foods Corp. v. Commissioner*, 76 T.C. 312 (1981).
  2. The courts have also recently held that the imposition of a "toll charge" is improper when the transfer does not have a tax avoidance purpose. *Gerli & Co. Inc. v. Commissioner*, 668 F.2d 691 (2d Cir. 1982) (involving a toll charge in a section 332 liquidation, discussed *infra*).
- D. Inbound transfers and reorganizations: I.R.C. section 367(b). Prior to 1976, all tax-free transfers required a ruling. It was recognized, however, that for inbound transactions (generally liquidations under I.R.C. section 332) and international reorganizations, rules could be established by regulation rather than on a case-by-case basis. Therefore, extremely detailed regulations have been enacted for dealing with the tax effects of these types of liquidations and reorganizations. *See generally* Clark, *New Temporary Section 367 Regulations*, 56 Taxes 405 (1978); New York State Bar Association Tax Section, *Report on the proposed Regulations under Section 367*, 34 Tax L. Rev. 79 (1978); C. Kingdon, *The Theory and Practice of Section 367*, 37 N.Y.U. Institute on Federal Taxation, Ch. 22 (1979).
1. Basically, for an inbound liquidation of a foreign subsidiary, tax-free status is granted provided the domestic corporation reports all of the earnings and profits of the foreign corporation as a dividend (a "toll charge"). Temp. Treas. Reg. § 7.367(b)-5 (1979).
  2. For other inbound transactions, primarily the receipt of stock of a domestic corporation in a reorganization,

nonrecognition treatment is granted provided the toll charge is paid. Temp. Treas. Reg. § 7.367-7(c)(2) (1979).

- E. Other international reorganizations. Whenever a U.S. shareholder continues to own directly or indirectly a transferred foreign corporation after an international reorganization, there is an attribution of the earnings and profits of the transferred corporation to the stock of the acquired corporation. This attribution involves several adjustments that are designed to assure that if a dividend is later declared or the stock of the acquired company sold, the earnings and profits of the transferred corporation will be taken into account and taxed.
1. There are several adjustments under Temp. Treas. Reg. § 7.367(b)-9. Basically, the earnings and profits of the transferred corporation are attached to the stock of the acquiring corporation that was received in the reorganization. The earnings and profits of the acquiring corporation are also increased by the amount of the earnings and profits of the transferred corporation. The earnings and profits of the transferred corporation are reduced to the extent that the acquiring corporation's earnings and profits were increased.
  2. If the acquiring corporation declares a dividend, this dividend will include the earnings and profits of the transferred corporation. If the stock of the acquired corporation is sold, then the earnings and profits that attached to this stock must be taken into account. *See* Temp. Treas. Reg. § 7.367(b)-12 (1979).

## VII. I.R.C. SECTION 482: INTERCOMPANY ALLOCATIONS

I.R.C. § 482 provides that if two or more corporations are controlled by the same interests, then the Secretary may allocate gross income, deductions, credits, or allowances between or among such corporations if such an allocation is necessary in order to prevent the evasion of taxes or to clearly reflect the income of any of the corporations.

By its terms, of course, section 482 is applicable in the case of both domestic and foreign corporations. However, in recent

years the primary application of section 482 has been in the international arena.

A. The principal effect of section 482 is to avoid the artificial shifting of profits to foreign affiliates.

1. Detailed regulations catalogue the types of transactions that will be subject to adjustment. The primary areas of application are inter-company sales, services, interest, and transfer and use of tangible and intangible property. *See Fuller, Section 482 Revisited*, 31 Tax Law. 475 (1976).
2. The question of whether a transfer is artificial or clearly reflects income is one of fact. The standard is whether the transfer was made on an arm's length basis; *i.e.*, did the domestic company deal with its foreign affiliate as it would have dealt with an unrelated party?
  - a. The regulations set forth detailed guides for determining an arm's length charge. *See, e.g.*, Treas. Reg. § 1.482-2(a)(2) (1980) (interest); § 1.482-2(b)(3) (1980) (services); § 1.482-2(e) (1980) (sales of property). However, a recent report by the Comptroller General to the House Ways and Means Committee (GGD 81-81, Sept. 30, 1981) concluded that only three percent of the IRS' recommended 482 adjustments were based upon a true arm's length price. The remainder were based upon hypothetically derived arm's length prices.
  - b. Needless to say, the hypothetical reconstruction of an arm's length price can be an extremely complicated and difficult question of fact. For example, in the trial court decision of *E.I. du Pont de Nemours & Co. v. United States*, 608 F.2d 445 (Ct. Cl. 1979), there are over seventy pages of fact findings involving 140 separate findings of fact.
3. In the case of international section 482 adjustments, there can be economic double taxation when the IRS increases the profits of a domestic company, but the foreign country does not allow a corresponding decrease in the profits of the foreign subsidiary. For example, if the IRS increases a royalty rate charged to a foreign subsidiary, the domestic parent has additional

income, but the foreign subsidiary may not be granted a larger deduction.

- a. One avenue of relief from such double taxation is the "Competent Authority" or "Mutual Agreement" clause contained in virtually all U.S. tax treaties. Under this clause, the taxing authorities confer and determine the appropriate relief to be granted in the foreign country.
  - b. Another method of relief is provided by Rev. Proc. 65-17, 1965-1 C.B. 833, which allows the domestic company to receive the amount of the section 482 adjustment as a tax-free repayment.
- B. Section 482 adjustments can have collateral effects.
1. A section 482 allocation can be made between two foreign subsidiaries, and this may result in a constructive dividend to the domestic parent. *See* Rev. Rul. 69-630, 1969-2 C.B. 112. The courts have not fully adopted the IRS' position. *See, e.g., W.B. Rushing v. Commissioner*, 52 T.C. 888 (1969).
  2. There can also be collateral effects on the foreign tax credit when the transaction is viewed differently by the foreign country and the IRS. *See Schering Corp. v. Commissioner*, 69 T.C. 579 (1978) (in which the court rejected the IRS' denial of a foreign tax credit for Swiss withholding tax on a Rev. Proc. 65-17 tax-free repayment).

## VIII. SPECIAL INTERNATIONAL CORPORATIONS

- A. Domestic corporations conducting business overseas  
Both the domestic international sales corporation (DISC) governed by sections 991 through 997 of the Internal Revenue Code and the possessions corporation governed by section 936 will be discussed in depth in Mr. Bradley's portion of this seminar.
- B. Foreign corporations
1. Captive offshore insurance companies will also be discussed in Mr. Bradley's portion of the seminar.
  2. An additional special international corporation is the international finance subsidiary (IFS). This type of corporation is formed in a tax haven, generally the

Netherlands Antilles, in order to raise funds abroad. The original purpose of the IFS was to avoid the imposition of the now-defunct interest equalization tax. However, international finance subsidiaries retain a value as vehicles to borrow in the Eurodollar market. The use of a Netherlands Antilles international finance subsidiary allows U.S. corporations to borrow large amounts of money at low interest rates without having to pay United States withholding tax on the interest paid to the European bond holders. *See Lederman, The Offshore Finance Subsidiary: An Analysis of the Current Benefits and Problems*, 51 J. Tax'n 86 (1979).



